**Franchise Tax Board**

# ANALYSIS OF ORIGINAL BILL

Author: Knight | Analyst: Kimberly Pantoja | Bill Number: SB 109

Related Bills: None | Telephone: 845-4786 | Introduction Date: 12/15/98

Attorney: Doug Bramhall | Sponsor:

**SUBJECT**: First-Time Homebuyer Mortgage Insurance Deduction


SUMMARY

Under the Personal Income Tax Law (PITL), this bill would allow a first-time home buyer, as defined, to deduct the amount paid or incurred for private mortgage insurance (PMI) each year until 20% of the mortgage has been paid.


EFFECTIVE DATE

This bill is a tax levy and would apply to taxable years beginning on or after January 1, 1999.

SPECIFIC FINDINGS

Private mortgage insurance is a type of insurance that protects lenders against losses from foreclosure. This protection is provided by private mortgage insurance companies and allows lenders to accept lower down payments than would normally be allowed.

PMI can be paid on either an annual, monthly or single premium plan. Premiums are based on the amount and terms of the mortgage and will vary according to loan-to-value ratio, type of loan, and amount of coverage required by the lender. Under an annual plan, an initial one-year premium is collected up front at closing, with monthly payments collected with the mortgage payment each month thereafter. Monthly plans allow a borrower to pay the lender only one or two months' worth of premiums at closing, with the balance paid on a monthly basis with the regular mortgage payment. Homebuyers can choose to add the amount of the lender's mortgage insurance premium (which is a percentage of the loan balance) to the loan amount. By doing this, homebuyers can reduce their closing costs and increase their interest deduction.

**Federal law** authorizes borrower-initiated cancellation of PMI once a consumer has accumulated 20% equity in his or her home, determined according to the amortization of the loan, any prepayments, or upon the borrower establishing that the property's value increased sufficiently to provide the borrower with a 20% equity position.

**Federal law** mandates automatic termination of PMI at the 22% equity level. For termination purposes, the point at which the 22% equity level is reached may be determined by payments made according to the initial amortization schedule. The only condition on this requirement is that the borrower must be current on all payments due on the loan at the time PMI is terminated; if not, the PMI must be terminated as soon as the borrower becomes current.

| Board Position: | | | Department Director | Date |
|---|---|---|---|---|
| ____ S | ____ NA | ____ NP | | |
| ____ SA | ____ O | ____ NAR | | |
| ____ N | ____ OUA | X PENDING | **Gerald Goldberg** | **2/22/1999** |

**Federal and state law** generally allow 100% of home mortgage interest to be taken as an itemized deduction. Certain miscellaneous itemized deductions (excluding home mortgage interest) are limited and may be claimed only to the extent that they exceed 2% of the taxpayer's adjusted gross income (AGI). Also, itemized deductions may be further limited for high-income taxpayers.

**Current federal and state laws** do not allow a deduction for private mortgage insurance.

**This bill** would allow a first-time home buyer to deduct an amount equal to the amount paid or incurred during the taxable year for PMI for each year until 20% of the mortgage has been paid.

By reference to the Health and Safety Code, this bill would define "first-time home buyer" as a person who is a purchaser of an owner-occupied housing unit and who neither has, nor has had, a present ownership interest in a principal residence at any time during the three-year period prior to the date on which the mortgage is executed.

The deduction allowed by this bill would be included with other miscellaneous itemized deductions and would be deductible only to the extent that the combined total exceeds 2% of the taxpayer's AGI.

## Policy Considerations

By allowing a deduction that is disallowed by federal law, the bill would create a state/federal difference that requires adjustments to income.

This bill would allow first-time homebuyers who purchase a house outside California a deduction for the costs paid or incurred for PMI.

The bill uses the term "first-time home buyer" as defined in the Health and Safety Code. The Internal Revenue Code (IRC) and PITL define the term "first-time home buyer" as an individual (and if married, the individual's spouse) who had no present ownership interest in a principal residence during the two-year period ending on the date of acquisition of the principal residence. It may be confusing for taxpayers to have two different definitions of the same term being used for different tax provisions relating to the taxpayer's home.

## Implementation Considerations

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

The term "PMI" is undefined. It is unclear what specific types of insurance payments qualify for the deduction. The federal "Homeowners Protection Act of 1998" provides a definition for PMI. The author may wish to use that definition in this bill. However, the federal definition excludes Mortgage Insurance Protection (MIP) required for certain Federal Housing Authority (FHA) loans.

It is unclear if a first-time homebuyer who refinances the original mortgage, for the sole purpose of lowering the interest rate, would still qualify for the deduction.

The bill should be amended to provide that the deduction ceases when equity has reached 20% of the original value of the property, so that it is clear that the term “amount” does not refer to loan interest or principal.

Calculating the equity percentage may be confusing to taxpayers. Since federal law requires that PMI terminate when 22% of the loan principal is paid, the author may wish to remove the reference to the 20% figure so that the deduction is available as long as PMI is paid (which will cease by law at approximately the same time as the 20% figure provided in the bill).

This deduction may also be complex for taxpayers to calculate since it would be included as part of the taxpayer’s miscellaneous itemized deductions and limited to the extent that the total exceeds 2% of AGI. However, the author has indicated that the bill will be amended to allow the entire deduction.

## FISCAL IMPACT

### Departmental Costs

Once the implementation concerns are resolved, this bill would not significantly impact the department’s costs.

### Tax Revenue Estimate

Based on limited data and assumptions discussed below, this bill would result in the following revenue losses under the PITL.

| Estimated Revenue Impact of SB 109<br>As Introduced 12/15/98<br>[$ In Millions] | | |
|---|---|---|
| 1999-00 | 2000-01 | 2001-02 |
| ($1) | ($1) | ($1) |

The bill would be effective with taxable years beginning on or after January 1, 1999, with enactment assumed after June 30.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

### Tax Revenue Discussion

The amount of PMI premiums paid that exceed the 2% of adjusted gross income threshold and marginal tax rates of taxpayers with deductible premiums would determine the revenue impact of this bill.

According to industry contacts, there are roughly five million PMI policies in force nationwide. About half of these policies are attributed to first-time homebuyers.

Assuming that:

- California's distributive share of PMI policies is roughly equal to the number of owner occupied homes in California versus the nation, or approximately 10%;
- an average monthly premium of $75;
- deductible premiums are roughly 8% of total premiums paid by first-time homebuyers (see discussion below); and
- an average marginal tax rate of 6%;

revenue losses would be on the order of $1.1 million.

As a miscellaneous itemized deduction, PMI premiums would be included with other miscellaneous itemized deductions, if any, and would be deductible only to the extent they exceed 2% of adjusted gross income. PMI premiums paid by first-time homebuyers in California are projected at roughly $225 million annually. It is not known what amount of projected premiums paid would reduce the income of first-time homebuyers. By using personal income tax sample data and a series of assumptions as a proxy, deductible premiums are projected to be on the order of $20 million annually.

The average PMI policy is in force for less than five years.

## BOARD POSITION

Pending.